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Business Advisory in Private Equity

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Abstract

The extraordinary growth of Private Equity over the use last ten years has led to this capital market sector becoming a fully-fledged industry with specific operational skills, methodologies and capabilities.

Private Equity is constantly seeking out new ideas and people capable of delivering better and better results and, for this reason it has become a growing user of consultancy services.

The relationship between consultants and Private Equity will grow in terms of quantity and quality, becoming steadily closer and more profitable whilst shared professional skills and capabilities will be increasingly respected.

Keywords: Management Consulting; Consulting; Business Advisory; Private Equity; Private Equity Management; Consultancy Services Private Equity

1. Private Equity Management

The extraordinary growth of *Private Equity* over the use last ten years has led to this capital market sector becoming a fully-fledged industry with specific operational skills, methodologies and capabilities. As an interface between the world of finance and corporate management, *Private Equity* is constantly seeking out new ideas and people capable of delivering better and better results and, for this reason it has become a growing user of consultancy services.

Whilst in the early days of management buyouts reliance on consultants was generally limited to due diligence (legal, fiscal, accounting and technology related), nowadays it is increasingly common to use a wide range of consultants including strategic consultants, marketing, human resources and organisational consultants, who are called on to provide support to *Private Equity* operations, both prior to and after the initial investment.

Furthermore the organisational structure that *Private Equity* operators have put in place, particularly the independent funds, is characterised by high levels of operational agility and by rapid decision taking processes. The inevitable consequence of this is great reliance on outsourcing for many of the activities undertaken during the life of an investment: from the initial analysis and assessment, to the post acquisition valuation, up to the final valuation and sale.

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Private Equity therefore nowadays relies to a great extent on different types of consultancy firms, so much so that in many cases consultancy services have created specific teams within their organisations dedicated to this type of client and to their particular needs in terms of contents and timeframes.

The fact that these skills and professional experiences are often interlinked has also led many professionals to migrate from consultancy to *Private Equity* and, in certain cases even to launch *Private Equity* initiatives, with some consultancy firms, usually strategic consultancy firms, raising their own funds. This has obviously led to a natural inclination within these operators to rely on consultants as well as to a more developed ability to put their contributions to the best possible use.

We have witnessed the above tendency in Italy too although consultants, especially management and strategic consultants, are probably used on a smaller scale because of the smaller average size of Italian companies. It is obvious that the cost of an outside consultant's work, in relation to his or her expected marginal utility, represents a critical factor when the *Private Equity* operator's investment is small-scale and when the investor is aware of the fact that it is running the risk of incurring significant costs without the certainty of being able to complete the transaction. Unlike in other countries, where the *Private Equity* sector is more mature, in Italy strategic/management consultancy companies have not yet reached a specific specialisation in providing services which match the needs and budgets of clients operating in the mid-market.

My intention in this article is to provide an in-depth analysis of the relationship between *Private Equity* operators and consultants, focusing particularly on strategic and management consultants, and attempting to highlight both positive aspects and critical issues[1].

2. Consultancy Services Demand from Private Equity

As *Private Equity* operators not using consultants for accountancy, tax and legal matters and - where appropriate - technical and environmental matters, are nowadays the exception rather than the rule, attention has shifted to other corporate consultants, those who are usually referred to as management consultants, in the various specialisations.

To start off I thought that it would be interesting to gain a deeper understanding of the reasons for this growth in demand for consultancy services. The situation which is revealed is enlightening.

First and foremost the frequency of use is on an upward trend. The majority of investors already regularly use strategic/senior management consultants in every project. This is so they can provide both salient information on which judgements can be based and suitable answers to those people, who, within their organisations, have to take investment decisions. Information is increasingly being supplied to external users, meaning the banks providing the funding, in the case of investments, and potential acquirers or stock exchange bodies, in the case of disinvestments. Another factor which has greatly encouraged the use of external consultants is connected to the fact that the vast majority of M&A transactions are

nowadays organised by means of rigid bidding procedures, and therefore *Private Equity* operators are, in a certain sense, forced to resort to external consultancy services. Indeed, the limited time allowed for due diligence and limited access provided to the company and its management, make it impossible for potential acquirers to achieve what they would like to achieve: to speak with the company's management directly and to gather information without the filter represented by shareholders and their M&A advisers.

For a potential buyer, who may already be a competitor of the target company, it is relatively easy to make up for this shortcoming, but for a financial investor who is taking an interest in that particular type of business, maybe for the first time, the difficulties are formidable. The only possible solution is to rely on consultancy firms which are specialised in providing this type of support. Companies which are capable of rapidly putting in place teams of professionals, often a great many, with specific due diligence experience who are capable of liaising with the other teams involved in the operation. In this manner a workgroup is created which can really increase the quantity and quality of the information and analysis to be provided to the client, at the same time complying with the stringent timeframes expected.

And this latter point is the critical area, today more so than in the past, considering the current competitive environment. In fact, *Private Equity* investors know that the greater the quality and quantity of information available, the greater the possibility of properly assessing the risks and potential of the operation and therefore of making a more competitive offer and winning the bid.

This change in M&A procedures paradoxically partly caused by the increase in numbers of *Private Equity* investors themselves and their increasing aggressiveness has led to a further evaluation in the relations between investors and consultants, including a steady increase in the areas to cover and the objectives of the assignment in the pre-acquisition stage.

The work undertaken by consultants frequently goes above and beyond the mere provision of support designed to gain a better understanding of the target company. Starting with an assessment of its strategic positioning, normally coupled with identification of critical success factors and analysis of the trends in key factors at stake in a specific business (including quantitative analysis), consultants often end up covering more specific areas, such as:

- determining the details of possible market scenarios to which one can apply a sensitivity analysis of the company's main business plan assumptions. This implies not only identifying critical areas in the market, in the company and in the business plan presented by the seller (irrespective of the fact that there may have been threats not disclosed to the potential buyer or simply that the company's senior management may not be aware of them), but also an estimate of their possible impact on future results, net of possible corrective actions;
- a correct estimate of resources needed to attain the objectives contained in the business plan;
- an assessment of internal procedures and related reporting, planning and control systems;
- an identification and analysis of growth opportunities, whether organic or external;

- the company's strategic appeal for potential sector buyers over time and, more to the point, on the expected future disinvestment date.

These are essentially extensions to the scope of action required from the consultant and in-depth analysis which go beyond critical analysis of the set of information about the company provided by the seller and which, if the timeframe and the availability of market information allow, tend to meet the financial investors' growing requirement to address three main issues:

1. closing the gap caused by asymmetrical information, something which penalises financial investors compared to competitors who already operate in the sector, so as to be more highly valued by the seller and, in particular by the management of the target company as capable partners who are able to quickly grasp the company's specific problems;
2. having a business plan which has been prepared and verified by one's trusted consultant, often involving a full discussion with the management of the target company, and on the basis of which it is possible to work out the most suitable financial structure for the financial investor and the banks providing the debt;
3. pinpointing the critical areas which will have to be worked on in future but which make value creation possible and, therefore, having an estimate of what proportion of future profits can already reasonably be reflected in the initial valuation.

Finally, there is another crucial aspect for those operating in *Private Equity*: evaluation of the management. Usually those who operate in this sector have developed strong personal evaluation skills and they therefore prefer not to delegate this type of decision, especially in respect of key senior managers. Unfortunately however, it is not infrequent that the amount of time allowed investors to get to know senior management is less than the time given to strategic consultants and, therefore, it is also often the strategic consultant who is asked to express an opinion in this regard.

In turn, not all the strategic consultancy companies like to be involved in these appraisals so it is becoming increasingly common to rely on Human Resources experts.

A number of leading headhunting companies offer specialist services designed to assess the top management, applying specific know-how, which is obviously unlikely to be available within the *Private Equity* operator's or the strategic consultancy companies as the latter lack knowledge about methods and experiences for conducting psycho-attitudinal interviews which in this situation are required to provide real added value for the investor. This type of support is particularly useful when it is not the manager who is being assessed, with his or her curriculum and references which can be normally checked, but an entrepreneur, possibly a second generation entrepreneur, who has only worked for himself, without being accountable to anybody else and whose ability to work harmoniously with the *Private Equity* operator becomes a crucial factor in the success of the investment. In this regard it is however necessary to highlight how use of consultants specially appointed to interview the managers or the entrepreneurs has often turned out to be a double-edged sword and one which investors realise has to be wielded with great

tact and care, especially in Italy. Top management often play a very important role in the final choice of the buyer and they may also have great influence during the sales process, favouring those they prefer over the others. For this reason asking for an assessment of the adequacy of the management team sometimes means getting off on the wrong foot in a situation in which the aim is to be chosen by these very managers. The consequence is therefore to give up on these experts and to ask the business consultant for an initial judgment, before deferring final analysis with the specialist, if required, to a later date after conclusion of the transaction.

Our hope is obviously that as time passes, this type of consultant too will also be accepted without suspicion and without hesitation as a normal request made by a diligent buyer.

Therefore, whilst up until a few years ago, it was *Private Equity* investors who played a direct role, often an important one, even gathering information and directly undertaking analysis and valuations, nowadays the approach has changed. *Private Equity* investors' involvement is less direct and takes place through the use of consultants with a range of specialisations. They guide, plan, organise and coordinate the work of several teams of consultants and receive an enormous quantity of documents, analysis and research which must be read, discussed, and studied and then summarised to benefit the internal decision-making mechanisms.

For the above reasons, this takes place particularly in the case of medium and large-scale operations, but the tendency is to extend this approach to small-scale operations. Indeed as the size of the funds looking to invest in this category of companies grows, operators have in any case had to steadily outsource a growing part of the due diligence activity in order to meet the requirement of increasing the number of investments made every year, and in this way reducing the amount of time used to invest the capital under management. In order to carry out more transactions they must focus increasingly on seeking out investment opportunities and then negotiating and driving deals; these latter tasks, by their very nature, can be less easily delegated than others. The consequence is that every *Private Equity* operator, conscious of the fact that there is a limit to growth in internal staff, which is correlated with the dilution of per capita earnings obtainable from managing a fund with a given amount of capital, will doubtless be able to take advantage from increasing outsourcing to consultants. Provided that these consultants are able to offer services which are competitive in terms of cost.

3. Critical Aspects of the Relationship between Consultants and Private Equity Clients

The above picture brings to light an aspect which is becoming steadily more important to the investor: investment decisions are taken more and more on the basis of analysis and information provided by others. On the one hand, it is necessary to learn how to better use the work carried out by consultants, carefully judging their work, and on the other hand it is necessary to establish professional practices with these consultants as well as relationships based on trust, so to make it possible to cope with the risks and uncertainties deriving by the fact that

decisions are taken on the basis of information which is increasingly analysed by external consultants not acquired directly.

In this regard my fairly limited survey reveals a very interesting point: consultants are increasingly being used but, in the final phase of the decision process, according to the opinion of the vast majority of my colleagues with whom I have spoken, their conclusions do not carry much weight in the investor's final decision. Above all in the decision as to the price to pay for the companies to be acquired which is clearly the key point in the investment decision process.

Asked to explain this phenomenon, I received different answers. The consultants argued that in reality, it is rare for them to be asked by the client to provide an opinion on the valuations and that, as they are hardly ever in the position of being able to see the whole picture with regards to all results of the due diligence analysis, they are unable to provide advice as to the price. More to the point, many consultants do not actually wish to give such advice which would mean they would be supposed to replace the M&A advisor, whose role it is to provide this advice. At most, strategic consultants believe that their view as the most likely results in the business plan on the basis of which the client, with its financing bank and its M&A advisor, can undertake all simulations on the various combination of the price-gearing-expected returns allowing him to take the final decision on price. Investors provide a different interpretation. They believe that consultants always tend to give a general overview of the problems without focusing on details and on practical assets and without providing precise estimates with numeric estimates which can be used to establish the price.

They point out that it is often difficult to receive from the consultant an accurate quantification of the over assessment or under assessment in relation to the plan received from the seller. For this reason they prefer to use the consultant in a manner which targets particular areas and clearly defined scopes, in order to limit the possibility of the consultant justifying the lack of precise feedback in his final report with the lack of time available or the lack of available information.

One could therefore conclude that when the consultancy company is asked to provide his judgement based on analysis of the target company business and market, rather than models to assess its efficiency or its policies and strategies compared to those of its competitors, the investors' level of satisfaction is high. Whereas when the consultant is asked to translate the results of this analysis into detailed economic/financial plans and, where appropriate, even criticising those provided by the company, plans which may be used by the investor for his final financial valuations, at this point problems may arise creating dissatisfaction in the relationship between consultant and client. In practical terms, when problems arise during a due diligence this means new requests for information and more detailed analyses, fee budgets to be rediscussed, extra time needed to complete the work, schedules which are not respected and both parties trying to pin the other party down for meetings, whilst the time available for due diligence goes by quickly. In these circumstances a strong relationship based on mutual trust between the investor and the consultants' project manager is fundamental. It is precisely in these cases, that, in absence of the necessary time to better understand the grey areas the consultant must draw from his or her own professional experience to provide the clearest possible answer to the client's questions and on top of that he

is also required to produce the most accurate possible forecasts. Whilst, on the other hand, it is precisely the consultant's professional experience in other previous transactions which allows the investor to profitably involve him in the most delicate decisions. In these situations, in the eyes of the financial investor, the consultant is the professional with proven judgement skills, the expert who has provided him with reliable forecasts in previous deal cases and with whom he can now share views, regardless of the brand that he represents and beyond, the analytical methods used and the efficacy of his presentations.

In this regard it is important to consider that it is generally speaking more difficult to build a long-term consultant/client relationship for a *Private Equity* investor vis a vis corporate client as a consequence of the multiplicity of sectors in which financial investors seek to invest and therefore the need to hire each time a different consultant with specific experience of that particular sector.

It can therefore be affirmed that, as happens in the world of investment banking, in every new project, consultancy companies ought to pair a consultant having a specific sector experience with a colleague who, over time, has built up a relationship based on trust with the client. But if both consultants are, out of necessity, senior consultants, the cost and organisational difficulty of allocating the necessary amount time often represents a problem for which it is difficult to find solutions. In addition it should be said that the investor, regardless of costs, prefers not to have additional "level of analysis" between those performing the due diligence work in the company and those who are going to use the results.

One factor which militates in favour of the creation of continuous, ongoing relations with consultants is the tendency on the part of *Private Equity* investors to use consultants not only for the pre-acquisition analysis, but also after the investment is made and not only if matters do not go according to plan, but always.

Nowadays, especially as a consequence of the growing competition, the search for over-performance has led to consultants being used throughout the life of the investment, mainly for the following purposes:

a) to provide company management with specific customised support for every possible improvement area;

b) to be able to check, on a regular basis, that all internal organisational aspects and market policies are being pursued as provided for in the business plan, a part from financial performance;

c) to help the investor introduce all changes that are necessary to the company systems and management methods, and to have them accepted in the company;

d) to report to the investor whenever it is necessary to change tack as well as when any opportunity comes up which the management has not been able to or has not wanted to highlight;

e) to bring attention to areas of weakness in terms of human resources, where action can be taken;

f) to prepare the company together with its management for the future disinvestment.

It should also be considered that in the case of projects in medium/large and large companies, if the investing partner asks the management to accept the use of consultants, generally serious problems do not arise, by reason of the fact that these

types of company are accustomed to the presence of consultants and are familiar with the relevant costs. In medium-sized companies however especially those which are family owned and run, the use of consultants often represents a problem not only in economic terms but also it can be something which is culturally difficult to accept.

Experience over the last few years bears witness to the fact that *Private Equity* investors have, without a shadow of doubt, played a very positive role in fostering the introduction of improved company management criteria, through the use of consultants. At the same time, also thanks to specific requests made by *Private Equity*, consultancy companies have prepared appropriate intervention modules with a cost benefit ratio which is also acceptable for medium-sized companies.

I refer in particular to fee agreements where by part of the fee is linked to the successful completion of the transaction as well as agreements that forsee discounts on work carried out on aborted projects but with set-off against future assignments on other successful completed projects with the same client. And neither are fee on performance systems so rare, especially for post-acquisition assignments, in which the consultant is paid according to the actual result attained, with a direct, proportional link to the increase in company's performance.

These are all payment criteria in which the consultancy company accepts that its cost for the company may be adjusted to match the results reached and in which therefore the consultancy company seeks a reward for the efficacy of the contribution provided.

In fact *Private Equity* investors are extremely pragmatic, maybe more so than other types of clients, and they usually focus on a tangible result which can be measured over the short term. Whenever consultants meet these requirements and are willing to run risks directly, they can find plenty of opportunities to work with *Private Equity* investors. However it is necessary to conquer trust on the basis of results obtained, on a case-by-case basis, also demonstrating that they are not averse to risk through greater inclination to produce estimates and forecasts even when it has not been possible for them to acquire all the desired information on which to base their analysis.

4. Conclusions

In my opinion, the fact that the majority of *Private Equity* operators, though widely using consultancy services, do not yet consider these services sufficiently important for purposes of deciding on the investment depends on the excessive vagueness of much of the consultants' output. Consultants have not always been successful in adapting their professional procedures to this type of client who does not simply need to know where the target company is going wrong or is weak or can improve, but how much this possible room for improvement is worth. For *Private Equity* operators diagnosis and prognosis, even though they may be performed well, are not sufficient; they need to know how long it will take to "cure the patient" and the performance level once the problem has been solved. They want more information, more data and not only historical analysis and elegant models. They need teams of consultants who are capable of taking apart, piece by

piece, the business plan created by the seller, preferably involving full discussion with the management, in order to assess every single component of it and, if necessary, replace it with a more reliable plan.

Between consultants and investors there are still some discrepancies regarding the modus operandi rather than cultural issues and there is still a mutual mistrust which can only be overcome by sharing experiences together and measuring results ex post.

I am personally convinced that the relationship between consultants and *Private Equity* will grow in terms of quantity and quality, becoming steadily closer and more profitable whilst shared professional skills and capabilities will be increasingly respected.

There is just one more issue which, to the growing concern of many, is to be raised: the matter of confidentiality and, related to this, conflict of interest. With regard to the first, it is seen as a particular problem in Italy, a market in which both investors and specialised consultancy companies are still relatively few and far between. There is a high risk that a consultant who is engaged by an investor/on the buy side may, at a later date, become the consultant for another competing investor or counterparty, when the company is subsequently sold. It is already well-known that there have been "bad experiences" over the last few years, which are increasing in number, and it is obvious that investors are worried about the situation. On the other hand, unfortunately, consultancy companies do not yet seem to be organised with internal systems in place to tackle this problem, as banks and merchant banks in particular have done. Therefore, just as the issue of confidentiality has created serious problems between investment banks and clients, notwithstanding the Chinese walls put in place (the workings of which are not always convincing), the same thing happens with consultancy companies and this aspect represents an understandable hindrance for investors, preventing them from involving consultants on a larger scale both during the pre and post- acquisition stages.

Another element about which *Private Equity* operators feel very strongly is the establishment of investment activities which are promoted or even managed within consultancy companies. In these cases the issue of confidentiality is compounded by a conflict of interests. These situations could give rise to serious problems for the companies, but, in general terms, this issue will certainly create obstacles to consolidate closer relations, based on trust, between consultants and their *Private Equity* clients.

Notes

[1] This article is based on selected interviews with *Private Equity* operators and management and strategic consultants